$40.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

Registered with the Securities and Exchange Commission

Copyright 1959 - Richard Russell

NEW MARKET? An increasing number of analysts are now venturing the opinion that this is a "different" market - that forces inherent in the 1959 business outlook will prevent any severe decline or reaction from occurring. The logic put forth by these analysts has been heard before. On March 14, 1936, during another boom, Rhea wrote, "I will stake whatever reputation I may have as an observer of the price movement on this statement - that neither the pressure of idle funds, outright ownership of stocks, nor inflation is any insurance against hurried liquidation." Holders of missile stocks received proof of this statement last week. The reason for the sharp decline in missile stocks may or may not be known, but the fact is- they did react. Experienced investors grow nervous when the economists turn bullish, and they are often willing to distribute the shares (which they own at depressed prices) as the good news comes out. They know that stocks are never cheap when the newspapers are optimistic, and they will, if necessary, wait years before entering the market again.

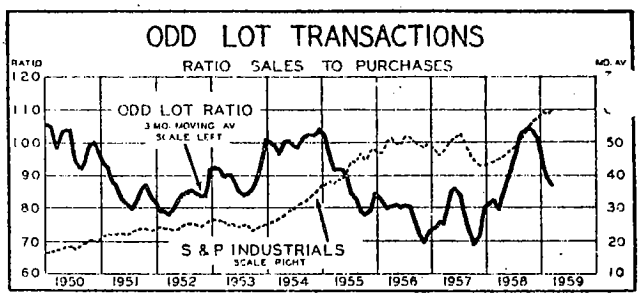
THE BRAVE BULLS. Studying last Sunday's New York Times, this writer counted thirty financial ads aimed at the bulls and one aimed at the bears. Twenty-one of the thirty bullish ads either mentioned or implied that they had specific groups or individual stocks which were buys. The lesson - cautious ads no longer sell subscriptions!

MANIPULATION? The following is from the market column of the New York Times, April 15, 1959. "Rails were exceptionally strong, influenced not only by steady improvement in carloadings over the year's dismal figures, but by a feeling in investment circles that, if the rail stocks confirmed the upward movement in industrials, the boom could continue. Thus, there seemed to be a movement to buy rails and create the proper emotional attitude for both rail and industrials." Although interesting, this paragraph displays woeful ignorance. The idea that investors would buy rails in order to manipulate that average and force it to confirm the industrials is something new in Wall Street annals. Hamilton once wrote, "Manipulation in the stock market is reported twenty times for once it occurs. It is the inefficient reporter's method of accounting for a stock movement which he has not taken the trouble to understand."

PATIENCE. Since the turn of the year over a thousand new readers have decided to subscribe to these Letters. Some of them are market veterans, others are complete neophytes. For this reason I will ask older readers to bear with me if I repeat market fundamentals or basic Dow Theory from time to time. Anyone who has followed this service for even six months knows that although helpful, the Dow Theory and this writer are far from infallible. The following observations may be in order at this time. (1) Those who expect least from the Dow Theory often gain most. (2) The Theory is not a method of "beating" the market. I have never seen such a system, nor do I believe one will ever be invented. (3) Investing on the impartial implications of the averages implies some losses, but Dow Theorists usually show a substantial margin of profits against losses over an extended period of time.

ODD-LOTS. During the last thirty years a few new and valuable contributions to market analysis have appeared; one of these is the odd-lot indexes. These were developed by Garfield A. Drew of Boston, whose work is well known and respected by all students of the market. Pictured below is a chart which shows S. & P's 500 stock index (dotted line) and a three month moving average (black line) of the ratio between odd-lot buying and selling.

When this ratio climbs above 100 it indicates that odd-lot sales are exceeding purchases; when it drops below 100 it indicates that purchases are exceeding sales.



The odd-lotter (the under-100-share trader, who is representative of the general public) is by nature an optimist - he seldom sells on balance in any kind of a market. In fact, as seen on the chart there were only three areas in the last ten years when the odd-lotter was bearish enough to sell more than he bought over an extended period of time. These outbursts of bearishness occurred (1) during 1949-50 when the primary trend had first turned up and the market was on its great swing from 161 (D-J industrials) to 293, (2) during 1954-55 when the market, beginning at the recession lows of 255 in 1953, climbed steadily to 521 in 1956, (3) last year as the third phase advance drove prices to all-time highs. Thus it can be seen that the public's greatest mistakes are made when the averages are forecasting a turn which is not apparent or understandable from a fundamental economic standpoint. Drew in his excellent book "New Methods for Profits in the Stock Market" puts the whole matter in a nutshell when he writes, "...a well-nigh universal disbelief that any important trend is possible is a prerequisite of the condition immediately preceding it, since otherwise prices would be moving rapidly in that direction as action was taken in anticipation of the event."

Now the odd-lotter normally is inclined to buy less or sell more as an advance first commences; he usually greets unexpectedly higher prices as an opportunity to unload. But the important thing is whether he continues to resist an advance or whether, on an advance, he grows bullish and begins buying on an increasing scale. Conversely, the odd-lotter normally greets a decline as a chance to purchase "bargains", but again the important thing is whether the odd-lotter continues to buy on a decline or whether he turns cautious and tends to switch to selling. A trend to the buying side during an advance is technical deterioration; a trend to the selling side during a decline is bullish and is an indication that the reaction may be nearing an end. In other words, the odd-lotter is not always wrong, but he is usually most wrong at or near the important turning points.

On a long range basis, we can see that the odd-lotter (who had been selling on balance since June, 1958) began to feel somewhat more bullish during January of this year, after the advance had progressed 170 points from the lows! At that time he switched to buying on balance and he has been on the buy side ever since. Technical weakness in the market will now increase in proportion to the extent that the odd-lotter is willing to step up his buying on a continuing advance. Sooner or later, if the advance continues and the odd-lotter buys more heavily, the advance will come to an end. For this reason it is said that the public tends to be wrong in degree; it increases buying or selling to important levels near or after the turn. The willingness of the odd-lotter to step up his buying during the current advance, and the degree to which he is willing to step up that buying is one of the things that market technicians are now watching. So far, the public's action can be termed normal (since they are back on the buy side) but cautiously bullish (since they are not yet buying heavily.)

APPRAISAL. A bull on the market can point to the frequent consolidations in the averages all the way up from the 1957 lows; he can point to the recent rail confirmation, the absence of climactic third phase volume, the fact that the rails have not yet bettered their 1956 highs, the cautious buying by odd-lotters, the still-present 3.3 million shorts, the many stocks and groups that have not bettered their 1946 highs, and the abundance of cautious talk from Wall Street.

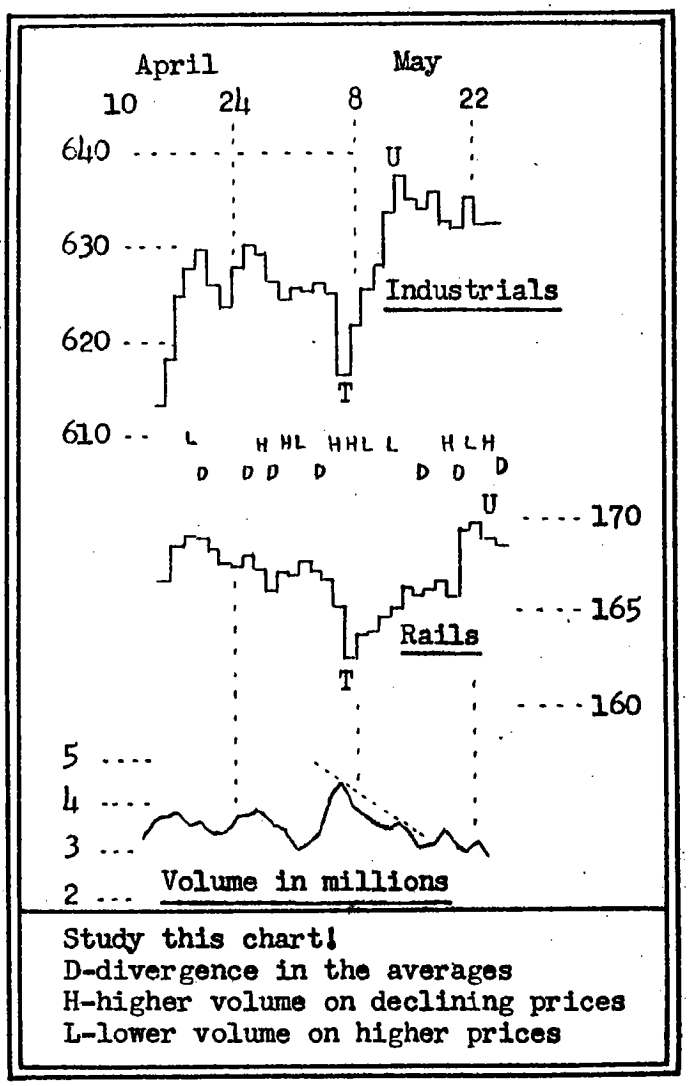
A bear can show you the 3.18 yield on the D-J industrials, the all-time high on the low-priced stock indexes, the uncorrected 220 point primary swing in industrials, the "high plateau" talk of the economists, the wide interest which the public is evidencing towards the market, the unprecedented heights at which many stocks are selling, the prevalent pre-

dictions of greater things to come, the lack of "values" on the big board, the absence of breadth (number of different issues traded) on the recent advance, and the current inability of volume to expand on rallies.

As far as I am concerned, it all boils down to this - that the period of great profits coupled with safety is fast drawing to a close. Despite what others may say, this is not an ideal accumulation area; it is an area of vicious selectivity in which it is increasingly difficult to buy stock "right". I receive many letters from subscribers who have sustained losses on recent purchases, but these were stocks that were bought while the crowd was buying, and there is nothing in the Dow Theory that implies accumulating stocks when the "boom" news is known.

On May 14 (pt. U on chart) industrials hit a new high of 637.04. Volume on the rally which produced this high had been steadily decreasing (see chart), and this fact was pointed out in Letter 66. Six trading days later rails spurted 3.45 points to establish a new high since 1956; this new rail high confirmed the recent industrial advance. But on this day volume actually dropped, and to make matters more difficult industrials closed down on the day (divergence). For the past three weeks the volume indications have been suspect - the tendency of volume has been to expand on declines and contract on advances. For this reason I remain cautious on the general market picture. Most Dow Theorists were amazed when volume dropped on May 21, the day rails hit their high, and any bullish inferences drawn from the recent action of the two averages must be held in abeyance.

Under Dow Theory, when previous highs are bettered by both averages, the significance of preceding lows is erased. It would now be perfectly normal for the averages to correct at least 1/3 to 2/3 of the last advance from T. It is the action following the next decline which is important. If, after the decline, both averages advance on increasing volume and better the highs (pt. U - industrials 637.04, rails 169.67) the chances of a further advance will be excellent. If, after the next decline, the two averages advance and volume recedes as the highs are approached we will be very cautious. Then if the averages, having (both) failed to better the U highs, turn down on increasing volume and violate the new decline lows it will be a bearish signal indicative of lower prices. However, if one or both averages can hold above the next decline levels and volume dries up on the second approach to those decline lows, it will be a hopeful sign and we may infer that an advance will eventually better the highs. It is also possible, of course, that the two averages are forming another "line" at this writing. I will repeat again that the validity of penetrations in an aging bull market grows increasingly weaker, and at the current level bullish signals (the bettering of previous highs by both averages) do not necessarily imply making new commitments.



The recently announced short position of 3.3 million shares brings the short interest ratio down to .96, the first time it has been under 1. this year. The short interest therefore ceases to be a plus factor. The yield on the D-J industrials is now 3.18, lowest since 1929. A yield of 3.18 has seldom whetted the appetites of informed investors. (Written May 26, 1959)

STOCKS. See Letter 66; nothing has happened to change my opinion.